SUBMISSION

Australia's Future Tax System

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After more than three decades as a field officer with the Australian Taxation Office I have acquired a good grasp of our taxation law and its acceptability in the community. I have put together the following two statements from my experiences, which expose the enormous gulf between what would be an acceptable tax system and what we have presently.

> Statement One
>
> The overwhelming majority of Australians do not object to paying tax. For them the diversion of economic resources from the individual to fund community programs is a necessary part of our society. They say that the taxes they are asked to pay should be applied uniformly to everyone, without exception. They demand that our tax system should be fair, avoidance proof and efficient so that everyone who is due to pay tax does so. Supporting this call is the conviction that if everybody paid their share of tax, the rates overall would be lower providing a benefit to all.

Sadly, this same majority also believe:

> Statement Two
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> That our present tax system is unfair, inefficient, widely rorted and favouring the wealthy. It allows those with the knowledge, influence and resources to arrange their taxation affairs so that they pay as much or as little tax as they choose.

These two statements have been true for decades and demonstrate the failure of successive governments and their much vaunted tax reform agendas. With respect, the present review is destined for the same fate unless it addresses the <u>real</u> inefficiencies and the <u>real</u> equity issues that underlie Statement Two above.

If there is one principle that should guide the present review and its recommendations it is the unshakeable truth that

> *Every dollar of tax not paid by one taxpayer, for whatever reason, must be picked up and paid by some other taxpayer. (Total income is finite. As income dollars are moved from the tax net the dollars left standing must bear a greater load.)*

The above principle suggests that if a tax system is to be regarded as fair it should have only one function: to collect the revenue. If it is given more than one and steers benefits to one group or class, those who are not beneficiaries will feel marginalised. Our present tax system not only does this in spades but ignores perfectly acceptable and verifiable profit determining mechanisms and pompously substitutes one of its own manufacture which fails miserably. It then allows as deductions against 'assessable income' amounts that can play no part in the profit or income determining process. Effectively, such special deductions, however noble and desirable, sterilize income that should bear tax in every other respect. As tax concessions and allowances have grown so has the ability of taxpayers to take unintended advantage of them. Countermeasures must be now be couched in legal terminology as must any new benefits. The complexity that has taken over the taxation process has been caused by legal prescription being given precedence over underlying economic reality. The shortcomings in our tax system have too much design about them to be passed off as mere accidents or ignorance.

The most significant obstacle to tax reform, however, has been airbrushed out of public consciousness. This is the existence of what is known as, 'the tax industry' - tens of thousands, possibly over 100,000 tertiary qualified people, spending the bulk of their working lives managing the tax burden, including shifting it from one set of shoulders onto another. This mass of skilled professionals and their support staff add very little to the net worth of Australia and exist at a time when Industry is crying out for technical staff. While these talented individuals are engaged in their narrow assignments they are <u>not</u> developing more efficient solar panels; they are <u>not</u> working on greenhouse gas reduction strategies; they are <u>not</u> performing medical research or they are <u>not</u> managing a factory etc. This tax industry puts an enormous strain on the Australian economy and its demise ought to be squarely on the tax reform agenda. We can no longer carry this baggage along with us into our new century.

Strategy for Change

The writer believes that as the present tax system has been so thoroughly influenced by special interest groups and political interference, that redemption by amendment is now out of reach. Supporting this belief is the certain knowledge that our tax system is flawed at its most basic level. This flaw has been in our tax system from the beginning. It has given our tax system an inequitable bias that has been ignored and sidelined by all those who have some obligation to promote morality and good order – the professions, academics, politicians, the judiciary and office holders in government.

The flaw referred to has meant that a staggeringly high percentage of income generated in our economy annually is not being referred to the Commissioner of Taxation for assessment. Because this income is withdrawn from the taxation sphere and legally, it has the effect that it's owners' pay less tax than they should, making absolute nonsense of our progressive tax regime.

This fundamental flaw is the omission of a definition for the concept of income. This flaw is the point of origin for the complexity, the inequity and the manifest inefficiency of our present system.

There is no better starting point for an objective analysis of the problems of our tax system than its very first word. The word 'Income' in the title Income Tax Assessment Act is a mischief. It conveys the misleading impression that it is <u>all</u> income that is to be subjected to tax rather than <u>some</u> income. This false impression becomes a theme that is repeated in its 20,000 pages of legislation and supporting documentation. For example, Section 6.1 of the 1997 Income Tax Assessment Act displays a Venn–type diagram that painfully attempts to depict the income landscape – in the interests of simplicity. However the two orbits of income shown are mere sub-sets manoeuvring untethered in a universe of unspecified income. To make sense these two income sub-sets need to be circumscribed by the general conception 'all income'. But an all-encompassing outer circle of 'all income' would elicit questions from enquiring minds as to the nature and scope of income that is neither 'ordinary' nor 'statutory'. We do find this missing outer boundary, however, but as a textural add-on at section 6.15 ('if an amount is not ordinary income and is not statutory income it is not assessable income so you don't have to pay tax on it').

The presumed purpose of the depiction in Section 6.1 i.e., to trivialise income that is neither ordinary nor statutory seems to be working. The reality is that hundreds of billions of dollars of unrealised gains on real estate, shares and other capital assets are excluded from the tax net annually. These gains are income and are owned by those with a propensity to save rather than spend and therefore disadvantage middle to lower income earners. If all these dollars were made to carry their share of the tax burden the rates overall would drop significantly.

The exclusion of unrealised gains from the tax net is a trait that was inherited from the original British model of 1799. This first income tax merely listed five categories of assets and the income types emanating from them. A sixth schedule was added later to include dividends. This was the origin of our differentiated tax regime.

In the background paper, *Architecture of Australia's tax and transfer system* repeated references are made to the desirability of taxing capital at lower rates than labour because of the need to attract and retain foreign capital in a competitive world market (Refer, for example, to pages 171 and 176). These views seem to be firmly held and reflect similar views internationally. Such views would appear to have been persuasive in the past, since today capital, is taxed more favourably than labour in Australia. But has this position been properly presented? If we accept for the sake of the argument, that taxing capital income at lower rates than labour is both a legitimate and desirable outcome for Australia, should we not expect that other ways of achieving this same goal were exhaustively canvassed? On the basis of what has been presented it would appear that the mobility of foreign capital would not depend so much on the relativity <u>between</u> taxes on capital versus taxes on labour in Australia but on the absolute amount of tax on capital in Australia <u>versus the equivalent tax on capital in competitor countries</u>. A very obvious alternative would be to tax <u>all</u> income allowing tax rates to fall uniformly across the board. This would give Australia the same or greater competitive advantage that was sought by taxing capital lower than labour but without releasing the ogre of tax avoidance to prey on domestic revenue.

A lot more force could be added to the latter alternative by contemplating the amount of income presently escaping tax among the highest range of taxpayers and projecting this behaviour all the way down to the lower ranges. I would recommend those who support lower taxes on capital perform the following analysis on the BRW Rich 200 list. I would ask that they plot the growth of the published net assets of these individuals year by year and observed the percentage increase the succeeding year had over the previous year, where the data permits this. If they were then to compare the observed percentage increase in the net assets of these individuals with the highest published investment returns for that year they would find, in a significant number of cases, that gross investment return exceeded by a hefty margin. Remember that we are comparing a <u>gross investment return</u> with the <u>net return after taxation at the highest marginal rate and after their entire</u> <u>private consumption expenditure</u>. The only sensible conclusion is that significant amounts of income are not being presented for tax. This would seem to be one of the costs of our differentiated tax regime.

I am amazed and disturbed that no tables were included in the background paper revealing the extent of unrealised gains on shares and real estate over the last decade or so. These are vast pools of untaxed income that are precisely relevant to the current review. How is it that such a major feature of our nation's economic life can be ignored in a background paper on the tax transfer system where equity is a central concern?

My suspicions are that very powerful forces are at work demanding that the status quo in relation to our current tax regime be maintained at least in relation to capital income. In an attempt to gather some evidence to support my general concerns I wrote to the Treasurer (2006) and asked that he obtain the following information from the Commissioner of Taxation:

1) What is the number of BRW's Rich 200 individuals who are also to be found on the Commissioner of Taxation's own list of top individual tax payers?

2) How far down his list of tax payers does the Commissioner have to go before he has identified 50% of BRWs Rich 200 individuals?

The request, unsurprisingly, was politely refused on privacy grounds. My expectation was that the answers might provide an intriguing insight into the equity of our tax system. A high number for Question 1) might not be useful because of the scale of wealth we are looking at but a very low number would be a devastating commentary on our tax system and its claim to provide vertical equity. The response to Question 2) would underline this conclusion.

Fundamental Concepts

Because our tax system is fundamentally flawed we cannot rely on the accuracy of its terminology or processes. We must revert to 'safe mode' or first principles to get a clear idea how a simple fair and efficient tax system should be structured and administered.

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A man is said to be wealthy or rich because he possesses assets. Such assets allow him to potentially consume more than others of lesser circumstance. His ownership of assets implies a greater usage of Society's services than a poor man. It is therefore reasonable to expect that the possession of assets should be a factor in dividing up Society's tax burden amongst its citizens. But another man might acquire wealth and immediately spend it leaving him at the end of a year with the same value of assets that he had at the beginning. So wealth alone should not be the sole determinant for a taxation liability. Accordingly, a tax on income would be an equitable base for distributing the tax burden.

Income can be defined as <u>the increase in things of economic value that have been acquired by or are attributable to a person during a fixed period of time</u>. It should be noted that while the concept of income is easy to define its measurement is a little more problematic because, in every case, while measurement is proceeding income is being exhausted by spending.

By using terms such as capital, wealth, income, net assets and consumption, we are presuming firm boundaries that should properly be presented only as aspects of a more general conception.

Assets are economic resources. That is to say assets are stores of economic value or money or money's worth. Income is economic resources that have 'come the way' of an individual during an income period. Consumption is the depletion of economic resources during an income period being sourced from current income events or the disposal of existing assets. 'Economic resources' is the common language. Every dollar of economic resources is identical in value to every other dollar irrespective of where it came from or who owns it.

Since the engines of state run on economic resources and only individuals generate new economic resources the taxation process must only be about the measurement and diversion of these resources from the individual to the state. A taxation system that gets involved in saying that some economic resources are to be disregarded in the taxing process is performing a function that is bizarrely at odds with its primary one.

Having identified 'new economic resources' (income) as the thing that taxation is going to harvest from citizens the next step is to decide whether the rules to be set up to do the harvesting are to be specific or general. There are two competing philosophies for taxing income. Income can be taxed as <u>differentiated</u> income where the various expressions of income are taxed at varying rates. Or income can be taxed in its <u>undifferentiated</u> form where the various types of income are replaced by an amount of unspecified income.

Differentiated Income

Our present tax system taxes income in its many different forms. Salary, wages and common receipts received by individual taxpayers are taxed according to prescribed tax scales that do not make allowances for inflation. Capital gains, stripped of the effects of inflation, are taxed at concessional rates. Unrealised gains on shares and real estate are not taxed in the years that they are generated but when the underlying asset is disposed of. Numerous rules come in to play and dictate the manner and timing of a vast array of circumstances that apply to superannuation, long service leave and retirement and every private circumstance.

There is no point to describing further our present tax system. The basic information is there in the background paper. It is clear that our present tax system is becoming unworkable through its complexity, its manifest inefficiency and inequity.

Undifferentiated Income

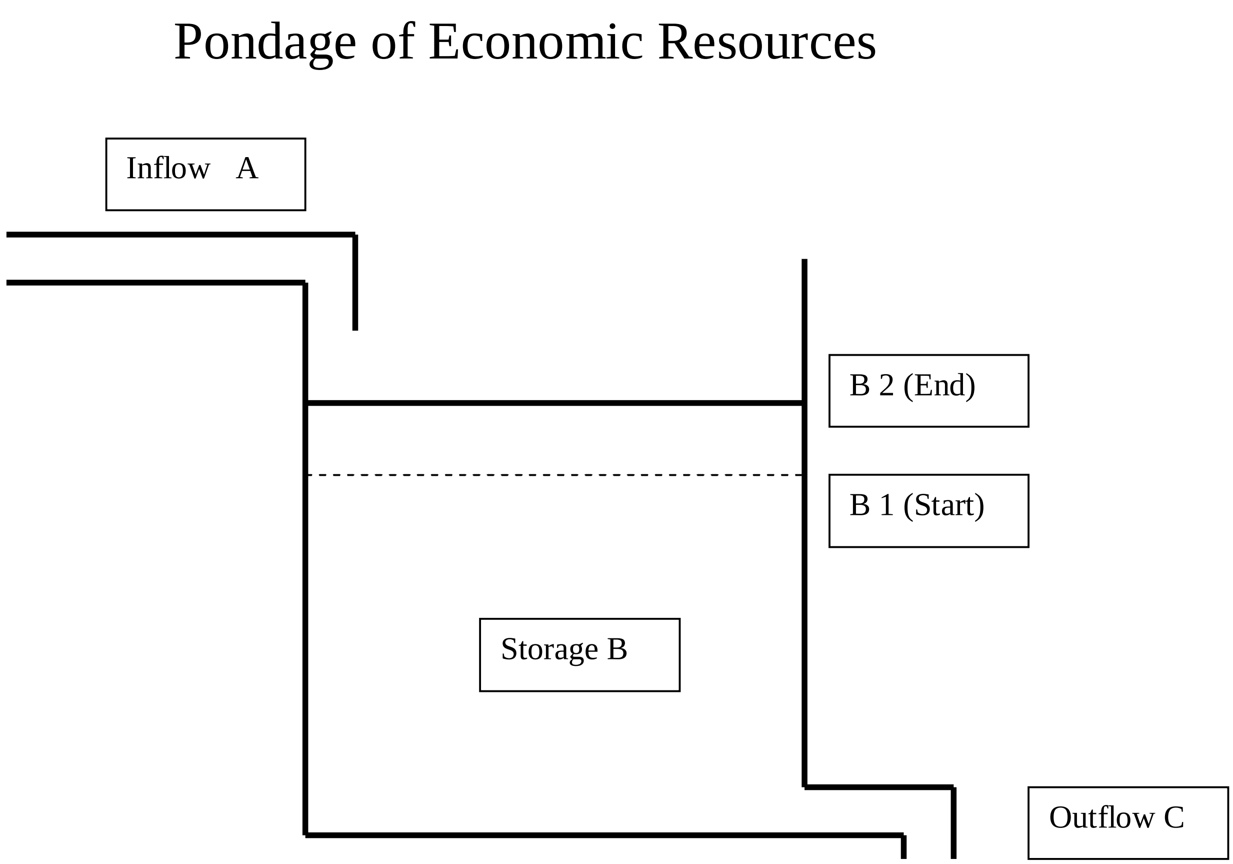
The undifferentiated income of a taxpayer will be the totality of economic resources that respond to the definition of income in a particular income year. Thus it will be this growth or increase in the totality of his economic resources in a particular year plus those resources that were devoted to consumption within that same year. Were our tax system to define income comprehensively all new economic resources however they came about would become part of the taxing process. This modification would be a chain-breaking event. We can now look at how breathtakingly simple, efficient, avoidance proof, and equitable our tax system might be.

Before proceeding we should pause briefly and pay homage to William of Occam and his famous principle, Occam's Razor. This states that where one is confronted with a choice between a simple solution and a complex one, invariably it will be the simple solution that will ultimately prove to be the correct one.

Measuring Undifferentiated Income

In simplified form the pondage of economic resources owned by an individual will consist of three features. There is the inflow stream of new economic resources; there is the storage pond itself; and there is the outflow of spent economic resources. To measure the amount of new economic resources (i.e., income) of an individual within this system we have two clear choices. We can simply install meters on the inflow streams and read off the numbers when the time comes. (This is differentiated income). Alternatively, we can put a meter on the outflow stream to record the happenings there but we must also install some means of measuring movements in the level of the pond itself. Under this alternative the combination of the outflow stream numbers and data on the changes in the level of the pond itself will reveal the same amount of new economic resources under the first option. (This is undifferentiated income.) Refer to Figure 1.

Figure 1



A is the inflow of new economic resources (i.e. Income)

B is the storage pond of economic resources (i.e. Net Assets)

B2 is the storage level of net assets at the end of the financial year – at current market values
B1 is the storage level at the start of the same year

C is the outflow of economic resources (Consumption)

Observations

1. Measuring the inflow alone has drawbacks in that it has no inbuilt checking mechanism.

2. Inflow A (Income) must be equal to Outflow C (Consumption) minus or plus the change that has occurred in B (Savings).

3. The change in B (B2-B1) can never be greater than Inflow A (Income). If it is then some part of the inflow is reaching the pondage un-metered.

4. Any change in B must come either from A or C or both – there is no other mechanism.

The logic of Figure 1 and the above observations are all that is required to set up a fair, simple and efficient income tax system or to criticise, authoritatively, our present one. No other features are needed in this income landscape

Today's income tax system taxes income directly i.e. by monitoring the inflow stream alone and it does this poorly as not all tributaries are metered and much flows around the meters (i.e, avoidance behaviour). Surprisingly, reform efforts have concentrated on better measurement meters rather than the location of those meters.

This submission is advocating a reorientation of our present income tax system from monitoring the inflow stream direct (A - the 'Traditional Method') to the two-step 'Economic Method'. Under the Economic Method the change in net worth (B2-B1) is added to consumption expenditure (C), identifying all income indirectly.

The Economic Method by factoring wealth into the calculation of income, fires a crossbow bolt into the heart of tax avoidance aspirations. This is because the goal of all avoidance activities must be an increase in assets but since the Economic Method monitors the very citadel of wealth, there is nowhere for avoiders to run, nowhere for them to hide.

By monitoring changes in net worth the Economic Method is exchanging words for deeds. The logic of a bank balance carries more weight than a well-articulated proposition. Income under the Traditional Method is 'what a taxpayer <u>says</u> it is'; income under the Economic Method is 'what it <u>actually</u> is'.

Perceived Benefits of an Undifferentiated Tax System

- Tax avoidance will be eliminated
- The income base will be unfurled to its fullest extent
- Tax rates will be much lower than comparable countries
- Costs of revenue collection will be significantly reduced
- Australian economy will benefit from the productive redeployment of tax professionals
- Because the elements of the Economic Method are already available to ATO it may be possible to eliminate annual tax returns entirely
- A transisitional opportunity may permit a significant amount of the welfare burden to be closed off against the reduction in tax
- Future wage claims will have the inflationary tax element removed

A Worked Example

Let us assume that you are middle to low-income taxpayer and that you returned a taxable income of $51,000 in your last income tax return and that this was an accurate account of your income. Your income came largely from salary, a little bit of bank interest and some dividends. A situation similar to yours would be reflected in millions of taxpayers' returns across Australia every year.

Most of your $51,000 income was received fortnightly from your employer net after tax. This money tumbled into your bank account each fortnight from which you met your rent payments and the balance used for groceries and entertainment etc. Over time you had managed to make some small share investments when your bank balance and tax refund permitted. The details of your tax return are shown in Figure 2, - gross income of $51,000 and a disposable income of 39,000. This method of measuring your income through your tax return is called the Traditional Method.

We will now look at how this income might be measured under an alternative method. You might only be vaguely aware that during that last year you had to make a decision about each and every one of your income dollars. The decision you took was whether to <u>save</u> that particular income dollar or to <u>spend</u> it so that by the end of that year you were left with two piles of dollars, so to speak, a pile of 'spent' dollars (or the husks thereof!) and a pile of 'saved' dollars. On this basis there can be no other option, each one of the income dollars must be either saved or spent.

A dollar is a 'spent' dollar if it is used to pay tax or used for private consumption or living expenditure, gambled, lost, or given away in such a fashion that you no longer had control over the economic power it exercised. On the other hand a dollar is 'saved' if it is used it to reduce a mortgage loan (but not to pay the interest) or if left it in the bank or used to buy shares or another asset like a car. (You will observe that the economic value in the saved dollars has been stored in some way so that it is still available for later spending)

Because your income had to be forced through either of the two gates labelled, 'spent' or 'saved', your $51,000 income can independently and accurately be ascertained by reading the odometer on each gate and adding the two totals together. The income calculated in this way is the same income looked at from a different perspective. This alternative method is the Economic Method. Your income calculated under the Economic Method is also shown in Figure 2

Figure 2. Proof that The Traditional and Economic Methods track the same income

Given Facts:

- Salary $50,000 (Tax deducted $12,000)
- Credit Card Balance 1July 20xy, $800
- Bank Balance 1July 20xy, $4000
- Shares $20,000 Bought extra $2000 worth during the year
- Dividends received $800 (unfranked)
- Interest received $200
- All accounts paid by credit card, which is paid off each month. Bills average $2000 pm
- 'Cash-out' at supermarket, $250 per week
- 'Tax' receipts show that GST of 2,500 of GST had been paid on expenditure

Traditional Method

Tax return:			
Salary	50,000		
Dividends	800		
Interest	200		
Taxable Income		51,000	$51,000
Tax Payable		12,000	
Disposable Income		$39,000	

Economic Method

		1 July 20xy	30 June 20xz	
Assets as at				
Bank		4,000	5,200	
Shares (at cost)		20,000	22,000	
Total Assets		24,000	27,200	
Less Liabilities				
Credit card debt		800	2,000	
Net Assets		23,200	25,200	
Change in Net Assets – i.e. 'saved' dollars			2,000	
Consumption Expenditure				
Debited to credit card	24,000			
'cash-out' at supermarket	13,000			
tax paid	12,000			
Total consumption spending i.e. 'spent' dollars			49,000	
Total gross income				$51,000

Notes

Bank	(4000 + 200 + 800 +38000 - 2000* - 22800 - 13000 = 5200) (bal interest divs salary shares credit card cash-out bal)	
(Credit Card	(800 +24000- 22800 = 2000) (bal debits repay bal)	

* This bank debit is for share purchases. It is NOT expenditure. It is merely a transfer of $2000 of economic value from one asset category – bank- to another,– shares)

Observations

1. The Traditional or tax return Method of income determination is based on 'what the taxpayer <u>says</u> his income is' whereas the Economic Method is 'what a taxpayer's income <u>actually</u> is.' It therefore has a much higher integrity

   If you failed to include your $200 interest in your tax return or maybe made a Mickey Mouse claim for expenditure you didn't actually incur they may not be noticed affecting a reduction in your tax liability. However, under the Economic Method these omissions or false claims would not affect your tax liability. This is because your net assets would automatically include your bank interest of $200 and be unaffected by any fictitious spending.

2. The idea behind Figure 2 is that there are two ways of determining income for tax purposes. On the one hand there is the Traditional Method and on the other we have the two-step approach where the change in net assets is added to consumption spending to get to the same result. So if consumption spending is to be seen as a 'component' of income under the Economic Method how do we reconcile it with the existing GST? The short answer is that the tax reforms that brought in the GST stopped mid-stream. The reformers did not go on and introduce some sort of a tax on net assets, which would have installed the full Economic Method <u>allowing the existing tax system to be fully replaced</u>. By stopping mid-stream the reformers created a greater problem than they solved. Some income – that destined for consumption - is now going to be taxed twice, once on derivation and again on spending while other income – that destined to be saved – will be taxed only once. To this extent the introduction of the GST was technically flawed.

   The negative effect of the GST on lower and middle income earners can be demonstrated in a line-up of all Australian taxpayers arranged from lowest income to the highest. Above the head of each taxpayer in the line is a label showing their total income and in front of each are their two piles of 'spent' dollars and 'saved' dollars. As we progress along this line we will notice one thing stands out more than anything else. This is the change in the relative size of the 'spent' dollar pile compared to the 'saved' dollar pile. At the lower end the 'saved' dollar pile does not exist or is insignificant, since all income, as you would expect, has to be 'spent' on living. But as we proceed down this line the 'saved' dollar pile grows steadily until by the time we reach the highest income earners the 'saved' dollar pile dwarfs the 'spent' dollar pile and by a very considerable margin.

This exercise demonstrates that people at the low-income end have a propensity to spend while those at the high-income end have a propensity to save. To be fair the GST did replace many other taxes and a compensation package was included but the compensation package was inadequate at the lower end and while the GST was solidly indexed for inflation the compensation was not.

The intrusion of the GST into our tax regime had the effect of shifting the tax burden from the wealthy taxpayers to the middle and lower income earners – or those with a propensity to spend rather than save. While I have not gathered the evidence, I believe that this movement in the tax burden may also have had a ballooning effect on welfare services.

3. While the example demonstrates that income determined under the Economic Method is the same income as calculated under the Traditional Method there is a fundamental difference that has not been revealed in the illustration. This is the critical question of valuing the net assets at the beginning and end of the financial year. You will see that the share values were recorded 'at cost'. This enabled the illustration to go on and produce an income that agreed with the Traditional Method. But any statement of assets and liabilities to have any meaning at all must record realistic values for both. The recording of assets and liabilities at their current market values will recognise new economic resources that are simply ignored by the Traditional Method.

   Suppose the share investment at 1 July20xy consisted of 3700 CBA shares purchased through the prospectus at the original issue price of $5.40 each (i.e.$19,980). Their market value at 30 June 2008, however, would have been $148,629 generating an overall unrealised gain of $128,649. In the context of the example given in Figure 2 the presence of this asset would have a dominating effect. It would be irrational in the extreme to ignore this added value in any statement of assets and liabilities. But to include it annually at its current value would be to recognise the contribution it makes to the economic circumstance of this taxpayer. The incremental gains posted annually <u>are</u> income and our tax system should be treating them as such.

Taxation and the Corporate Sector

An Australian company pays tax on all its income but whatever tax it does pay is refunded to its Australian shareholders as franked dividends after they include both the dividend and the franking credit in their tax return as income. Effectively the company's accounting income is being taxed at the marginal rate of the shareholder. So to the extent that a company avoids paying tax the Australian shareholder will be short on franking credits and he will have to pay tax on the dividend at his marginal tax rate. Conversely, if the company pays full tax then the shareholder will get the full tax credit available and his dividend will effectively be tax-free.

If the tax paid by the company were simply refunded to the shareholder, who must then make up any difference, it would be reasonable to expect companies to ignore tax-planning and get on with the business of making profits knowing that any tax they do pay is going to be refunded to shareholders anyway.

Also an alert government would recognise the absurdity of the present arrangement and simply exempt companies from paying tax. Along with this it should then – as a practical measure - exempt dividend income in the hands of shareholders. Replacing both taxes with a final dividend withholding tax on all dividends paid or deemed paid. The economic benefits of this would be significant.

Neither of the above outcomes have happened or even been contemplated. Why is this? Surely company management would realise that from a shareholders point of view it matters neither jot nor tittle whether the company pays the full amount of tax or not much. If the former then the shareholder will be entitled to maximum credit; if the latter then shareholders will receive a greater dividend as a consequence and have to pay the tax themselves – out of the higher dividend payment. The net benefit to the shareholders would be the same in both cases. Since the shareholder must in the end pay the tax not paid by the company the act of paying tax by a company would seem to be a pointless exercise.

The only possible reason for companies wishing to retain the present system of taxing one sector and refunding it in another is that somehow companies are minimising tax but illegally obtaining access to franking credits. <u>If this is happening on a large scale then Australia's tax regime is totally corrupt and we are no better than any third world country.</u> The conversion and use of franking credits in this way relieves one group of shareholders of tax and simultaneously placing that burden on the shoulders of other taxpayers.

<u>I have been unable to get access to any evidence that the practice of franking credit trading is taking place on a large scale.</u> <u>But the loophole is there and it has been known about for many years with no action being done to prevent credits that have already been given in another country from being used again in Australia</u>.

Those companies that derive a significant part of their income from overseas realise that their shares are less attractive to Australian shareholders because of the low level of tax credits available. Such companies are understandably 'very interested' in ways of acquiring tax credits from other companies, which for any reason can't use them. There is therefore a large <u>'demand' balloon</u> over the corporate sector. This balloon symbolises the enormous desire for franking credits, annually, by some Australian companies who do significant business overseas – banks, mining companies etc.

Foreign investment in Australia is often done via an onshore holding company, which owns all the equity in the local operating company. Foreign tax authorities apply their own rules when providing relief from double taxation under tax treaties. For example the IRS will grant relief for income taxed in Australia (under Code 901) on the presentation of a paid assessment notice of the tax paying entity in Australia. However, later, when the local operating entity pays a dividend to its onshore holding company it will be fully franked dividend even though the underlying credit has already been applied in the US by means of the paid assessment notice. Thus a huge <u>‘supply’ balloon</u> is now hovering over the corporate sector, symbolising annually the availability of franking credits –unusable by US companies but desperately needed by Australian companies with substantial business activities overseas.

No reasonable person would say that Australian <u>company tax that has already been allowed once as a credit overseas should also be allowed, again, to other Australian shareholders through some arrangement</u>. Clearly the legislation is deficient here. Such franking credits should have been cancelled or rendered unusable.

Let us say that there is $10 billion of company tax credits floating about in the economy and that $2billion of this is acquired by Australian companies for the purpose of paying fully franked dividends to its shareholders. What this means is that Australian shareholders will not have to pay $2billion in tax each year. But if the $2billion was not available they would have to pay and the Revenue would be $2billion ahead. This would add to the Budget surplus and be available for ‘tax cuts’ to middle and lower income earners.

We must be careful here. All we have identified at this stage is a risk but it is a massive risk and one that raises some interesting questions. For example, our Australian tax authority goes to great trouble each year in swapping dividend and interest payment information with corresponding tax authorities where the recipients apparently reside. They do a sterling job in catching people like backpackers who have left a small credit balance or a share investment in a foreign country and had ‘forgotten’ to declare interest or dividend income.

Wouldn’t it be reasonable to expect that our Australian tax authority might contact their US counterparts and seek details of all Australian company tax credits that have been applied in the US in any particular year? Armed with this list it might then approach those Australian companies whose tax had been applied in the US and ask them to account for the corresponding franking credits. Such companies would be expected to point, perhaps nervously, to the onshore holding company recipient who would be asked to explain the present whereabouts of the franking credits they have no use for.

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Rather than discuss the myriad of taxation issues in the corporate sector this paper recommends only that the corporate sector be exempted from tax entirely and that the dividends they pay should be exempt from tax in the hands of their Australian resident shareholders. However as a practical measure the paying company would be required, as paying agent, to break off part of the dividend and remit it as a final withholding tax to the Commissioner.

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A Replacement Model for a New Tax System

Overview

The replacement tax system being proposed will be based on the following ideas

1 Income will be comprehensively defined so that it captures ever dollar of economic income attributable to Australian taxpayers.

2 The new tax system will determine tax obligations under the Economic Method and tax liability will be met through a revamped GST and a tax on a net assets above a certain threshold

3 A National Welfare Fund to be established which would finance all welfare needs of taxpayers in which each taxpayer would own his share. This fund will absorb most of the expected tax adjustments brought about by the new tax

4 Corporate business will be exempt from taxation but will be required to remit a part of all dividend distributions to the Commissioner of Taxation as a final withholding tax.

5 Interest payers will likewise be required to retain and remit to the Commissioner of Taxation part of interest payments as a final withholding tax

6 Tax expenditures will not be part of the new tax system. These will have to be met by special grant from Department of Finance.

7 Individual taxpayers will be divided into Block A and Block B taxpayers depending on the level of their net assets.

8 The Income Tax Assessment Act and related acts to be repealed.

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Essential Features

National Welfare Fund

With the expected lower tax rates the majority of taxpayers will be paying less tax. This will lead to significant reductions in tax across the board. It is proposed that most of the tax adjustments be diverted into a national welfare fund in which each taxpayer will own his share.

The National Welfare Fund will be responsible for all welfare needs including superannuation, sick leave, holiday pay, long service leave, medical, unemployment needs etc. The taxpayer's account will be transportable and will form part of his estate. It is expected that because taxpayers will effectively be funding their own welfare they will be parsimonious in their use of it.

It may be desirable to have a cap on contributions retained in the fund, which would relieve wealthy taxpayers of making further contributions until total assets fall below that limit. The fund should also accept voluntary contributions.

Transfers from individual taxpayers to the National Welfare Fund should not be viewed as taxation since each aspect of the transfers will provide a benefit to each taxpayer In this way a substantial amount of current federal taxation can be made to 'disappear'.

Since not all welfare recipients will be able to fund their own welfare the Centrelink function would need to be retained but Centrelink itself could be folded into the National Welfare Fund where it could access some part of the fund's assets. .

In summary the National Welfare Fund will provide that basic level of welfare that the community expects. Taxpayers would not be expected to contribute directly for someone else's benefit, though indirectly they will. The use of Fund assets to pay unfunded Centrelink benefits might be offset by a federal and state government guarantee of fund assets, a minimum return and direct contributions by government..

The transitional tax adjustment would be Australia's last chance to get the tax system right before 'baby boomers' put untold pressure on our tax –transfer system.

Block A Taxpayers

These taxpayers will be those individual taxpayers whose net assets exceed a threshold to be determined plus all unincorporated entities, trusts etc whose net assets are to be unaffected by the threshold. Even though the theory of the new tax arrangement is to tax income under the Economic Method some practical adjustments will have to be made to that method.

Rather than requiring taxpayers to account for changes in their net asset position it may be more practical to simply deem a flat percentage of net assets to be income. Say 10% of net assets may be deemed to be income each year. This 10% will then be taxed at the flat tax rate to be determined.

This modification will have two advantages. First it will allow the government an economic manoeuvring lever, which will not affect the tax rate. For example if the economy requires stimulation then a lower percentage of net assets will be deemed to be income instead of the usual 10%. The second advantage is it will ensure revenue flows in periods of falling stock and property values.

Because information on the assets and liabilities of taxpayers are already on computer databases available to the Commissioner of Taxation so it may be possible for taxpayers to lodge only occasional statements of assets and liabilities or on request.

Cooperation of local governments will be required in that some standardisation of property valuations will be an integral part of the new process.

Initially Block A taxpayers will be asked to provide a statement of assets and liabilities possibly with the last traditional tax return they will furnish. This will be the foundation stone of the new tax system. The net assets so revealed will not be taxed in this first year but will be compared to the equivalent statement at the end of the following year. The growth in net assets over the year plus consumption spending will be equivalent to their income under the current tax system. As the GST takes care of the need to tax consumption spending all that remains is to tax the growth in net assets in some fashion to completely tax income under the new system.

In the inaugural year some taxpayers will be faced with a dilemma. Should they disclose all assets or should they attempt to understate them or overstate some liabilities? If they understate them then subsequent statements will suddenly be larger by the amount of the understatement. It is clear that it is better to be open and honest from the start.

Trusts and other legal entities will not be granted the threshold exemption. They will similarly be asked to furnish a statement of assets and liabilities similar to other Block A taxpayers. Some trusts will have received loans from related individuals at favourable interest rates. Such loans will have been invested in assets that have increased in value because of the favourable rates. This value will be taxed to the trustee as part of the net assets. The low interest loan by the related party will also form part of the Block A taxpayer's net assets.

The most controversial element of the proposed scheme is the annual valuation of assets at full market rates. This will mean that anyone with property and shares will have any unrealised profits on those assets automatically factored into their tax calculation.

The net assets of Block A taxpayers will include the proceeds of net dividends and net interest received from other Block A taxpayers and from Block C corporate/business taxpayers. No special treatment will be required in respect of these receipts. They will find their way through bank accounts to other assets or will be used to retire some debt or be spent.

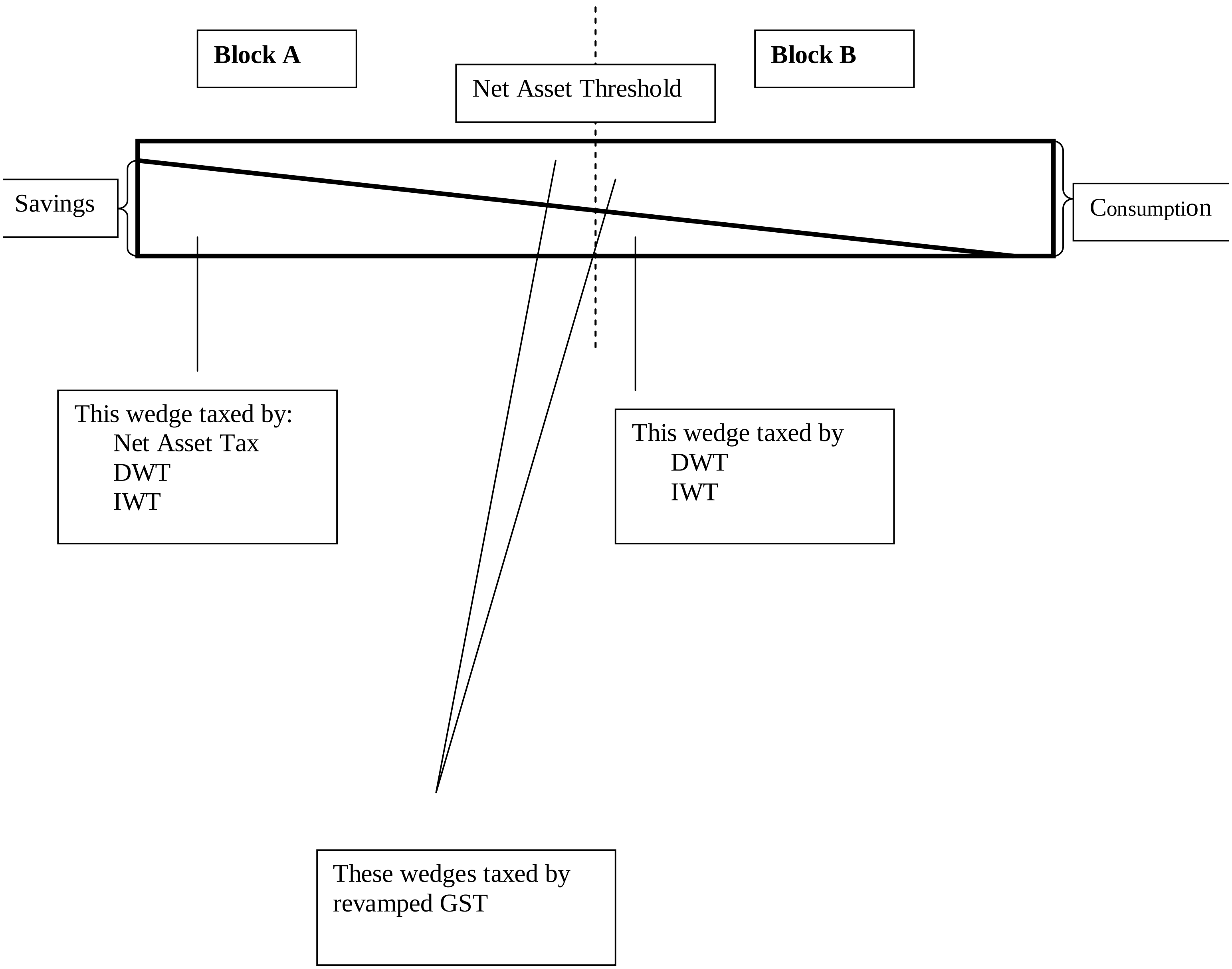
Block B Taxpayers

If we look at the continuum of taxpayers from lowest income earner all the way up to the top income earners we will notice that their asset accumulations will follow a fairly well defined path. Those at the very bottom of the income scale will not be able to accumulate any assets at all as they will include those on some form of government benefit. As we move along the scale most will be occupied with home finance and a small bank account. Further along the income scale a few will have shares and investment bank accounts then investment properties and holiday homes. A commanding feature of taxpayers at the lower end of the income scale is the relative absence of financial assets and hence income from that source.

It is proposed that we divide the continuum of taxpayers into two parts - Block A taxpayers and Block B taxpayers. The division will be made on the basis of a net assets threshold yet to be determined, say, $500,000. Those taxpayers with a net asset position over this figure will be Block A taxpayers. Those under will be Block B taxpayers. This division between Block A and B is an arbitrary one made on the basis of a net assets threshold, which will have to be carefully thought out. It is assumed that little revenue would be obtained by insisting that Block B taxpayers be asked to submit a statement of net assets when they will most likely have little in the way of assets save a heavily mortgaged family home. The $500,000 threshold could also bee seen as an allowance for the family home.

Block B taxpayers will be subject to only the enhanced GST and whatever IWT and DWT have been deducted on their small investments. However when their separate contribution to their own account in the National Welfare Fund is taken into account Block B taxpayers may not be paying very much less than they are paying now.

Figure 3 **The Taxpayer Continuum**



Block C Taxpayers

Block C Taxpayers will not be taxpayers at all. It is proposed that all business and corporate taxpayers will be entirely freed from the obligation to pay any tax whatsoever. The reason for this is that as an accounting entity their whole orientation is to provide profits to their proprietors. It is proposed that this block of taxpayers will be more expansive than the corporate sector presently as it may be practical to encourage business to incorporate.

While Block C Taxpayers will not strictly be taxpayers they will be enlisted as agents. They will be required, on payment of a dividend, to break off part of it and remit this part to the Commissioner of Taxation. This tax will be a final withholding tax on that dividend payable by Block A and Block B recipients.

Because Block C taxpayers will be freed from the obligations to pay tax they will need close monitoring to prevent diversions of profit before the point of distribution. In this respect the professional auditors who currently audit companies on behalf of shareholders and other stakeholders will be required to perform this same function but on behalf of the Commissioner of Taxation for the benefit of the revenue as well as the shareholders The Commissioner will be authorised to appoint all auditors who will report back to him in the first instance.

Having auditors appointed by and reporting back to the Commissioner of Taxation in the first instance will ensure that the audit process is free from bias and interference. This contrasts with the current situation where auditors are appointed by the shareholders on recommendations from the board of directors. Auditors quickly learn that the less waves they make and the lower their costs are will ensure their reappointment and, more importantly, non-auditing work is likely to be received. Therefore there is a very real potential for auditors to be 'too understanding' of the company they are auditing. By breaking the appointment connection the Commissioner is freed from providing his own staff to provide the audit function and can rely exclusively on the accounting professionals. Accompanying this change might be a levy on all companies to cover the cost of the audit function.

The profits of the corporate sector calculated according to accounting principles will be the basis for distributions to shareholders (as they are now) and therefore for the withholding tax. While the Commissioner will have a role in policing the appointment and reviewing the audit process he will have no say in income determination.

Because some companies will be private companies there may be resistance for dividends to be passed on to shareholders. The Federal Treasurer by declaring a minimum retention rate will deal this with this. The retention rate might be another economic tool available to the federal treasurer to be varied, as circumstances require.

Tax Expenditures

Tax concessions are not an efficient way of delivering benefits. They do not allow proper scrutiny because the Commissioner of Taxation is frequently not given specific resources to monitor eligibility. Also the ranking a benefit might hold in one year in terms of national priority, might be quite different in a subsequent year and would not have been given had the benefit been funded directly. The background paper does not reveal the extent to which some claims are defective but from my own experience up to one third of investment allowance claims I examined were in some way defective. I have seen measures designed to stimulate the local manufacturing only increase imports of foreign-made goods.

It is my judgment that the cost of maintaining a separate agency within the Department of Finance to oversee industry concessions through a grant application scheme would be beneficial to the Australian taxpayer. Applicants would be required to vouch for the accuracy and eligibility of their application.

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GST

This will be levied on all consumer spending. Because this will be the only tax that the majority of taxpayers will pay directly it will have to compensate for the loss of revenue from PAYG it's rate might have to be increased and its extension to all food items would have to be considered.

Internet Transaction Tax (ITT)

Such a tax may be necessary because people are increasingly purchasing goods from overseas. Basically, anybody ordering goods from overseas will be required to pay ITT before goods will be released from Customs. Prior to completing their purchasers a taxpayer will visit the ITT website, key in their Tax File Number or equivalent identification together with name and address and description and price of the goods and pay the nominated tax. They will be issued with a bar-coded receipt number, which is required to form part of the return address label. When the goods arrive Customs will be able to link the package to the purchaser. This tax is needed because the pair of jeans, if that is what the item in discussion is, represents a sale of goods in Australia that has not been subjected to GST. No tax, no goods.

Interest Withholding Tax
Dividend Withholding Tax

As indicated above these two taxes are a compromise in the interest of efficiency. There are two reasons why I have proposed these additional taxes. The first is that even though the income underlying these two taxes would theoretically be picked up and taxed under the net worth tax it would be much more efficient to bleed off revenue at the choke-point where it is paid to the taxpayer and then reduce the amount of the net worth tax   The second reason is that it would introduce equity into the Block B taxpayer group where those at the top end of that group would contribute to the revenue progressively more as their asset bases grow through investment assets.

A further reason for the two withholding taxes is that they would be required to enable non-resident taxpayers to make a contribution to the revenue and to enable them to seek tax credits in their home country.

Ronald P Winthrop

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